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Director of Central Intelligence

NATIONAL INTELLIGENCE DAILY

Wednesday, 9 August 1989



Approved for Release
Date JUN 1999

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IRAN-LEBANON:

Situation Report

**Tehran Resurfaces
Old Hostage
Proposal**

Political maneuvering within Iran may have forced President-elect Rafsanjani to take a step back from statements he made last Friday. An article yesterday in *Tehran Times*—which often serves as a vehicle for Rafsanjani's views—demanded the release of Iranian assets frozen in the US in return for Iranian help in freeing the hostages. Although Rafsanjani's remarks on Friday were couched in hardline rhetoric, they did not stipulate specific conditions for helping the US.

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Comment: This is the same response Rafsanjani has given since 1986 whenever asked publicly if Iran is willing to help the US gain the release of its hostages. The most recent *Times* statement was probably a signal to Rafsanjani's critics that his gesture on Friday was not intended as a deviation from Iran's longstanding conditions for seeking the release of hostages.

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Concern About the
Middle East Process**

Washington's handling of the Lebanese situation appears to have reassured West European leaders of its ability to keep the Middle East process on track. The West European press has generally praised US military restraint and its use of diplomacy. In the only official West European comments on US actions to date, Italian Foreign Minister De Michelis said on Monday that Rome would not support military retaliation.

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Comment: The hostage crisis in Lebanon underscores for West Europeans how quickly events can unravel the most carefully constructed Middle East peace proposal. West European leaders are likely to oppose the use of US military force except under extreme circumstances, such as the systematic murder of the remaining hostages.

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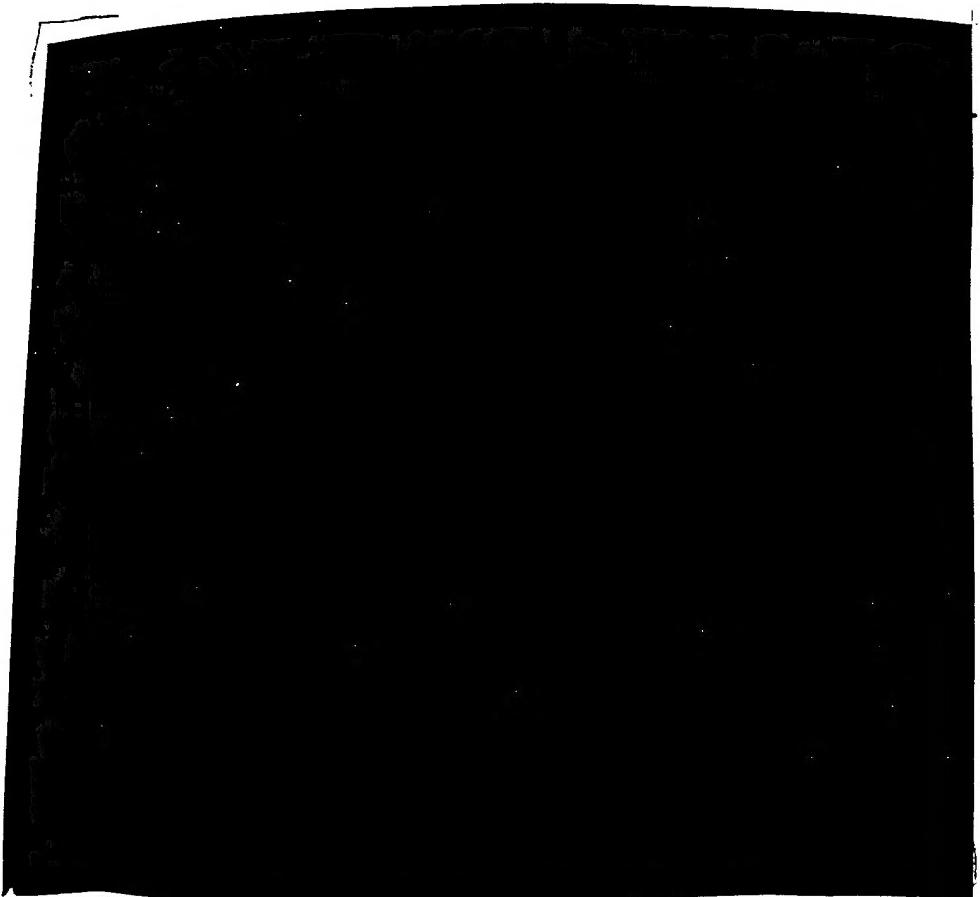
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USSR:

Balance Sheet on Supreme Soviet's First Session

The new Supreme Soviet has already emerged as a major political institution, although the party and the ministerial system still get in the way of its ability to legislate independently. b3

President Gorbachev told Soviet newsmen last weekend that in his view the Supreme Soviet is now the nation's "highest body of power" operating on a day-to-day basis, performing the crucial functions of lawmaking, administration, and oversight. The invigorated legislature was surprisingly reform minded, quick to get involved in major developments that occurred during its deliberations. b3

The Supreme Soviet has taken flak from the right and the left for the way it has exercised its powers. One regional party secretary charged [redacted] that some of the legislature's decisions were based not on professional knowledge but on emotion. Reformist deputies have complained that its operations are manipulated by the heavy hand of the party and government apparatus. b3

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[redacted] Although Gorbachev exaggerates the institutional power of the Supreme Soviet, it has already become a major force on the political scene—to the obvious consternation of many party officials concerned about their eroding role. It has been able to capitalize on its aura of electoral legitimacy and its newfound credibility with the Soviet public but is handicapped because the staff and the expertise needed for legislative drafting are still in the hands of the Central Committee departments, the ministries, and the academic institutes.

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[redacted] the party would keep control over foreign policy, partly because the Supreme Soviet did not have enough expertise in that field. It is uncertain how soon Supreme Soviet deputies, who are now housed in Moscow hotels, will acquire facilities and staff—and skill in using them—that will let them participate fully in the legislative process and oversee government operations. The new legislature is sure to encounter stiff resistance from party and government institutions as it seeks to expand its influence. b3

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IRAN-AFGHANISTAN: Tehran Playing the Kabul Card

President Rafsanjani apparently is signaling willingness to accept Communist participation in an Afghan coalition government. The *Tehran Times*, which usually speaks for Rafsanjani, said recently that participation by the Najibullah regime in talks to settle the issue could be discussed and accommodated. The paper said many members of the Kabul regime remain faithful to their homeland and desire independence. It called for negotiations that would include all Afghan groups, Iran, Pakistan, and the USSR. b3

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[REDACTED] Tehran has steadily improved relations with Kabul since the Soviet withdrawal but still officially opposes Communist participation in a post-withdrawal government. Rafsanjani's apparent approval of a Communist role implies a new willingness to adjust Iran's regional policies to serve its broader interest in better relations with Moscow. Iran also is disappointed that the Sunni-dominated interim government has failed to include what it regards as enough Shia representatives and may believe strengthening the Communists at the expense of the seven-member alliance will better help [REDACTED]

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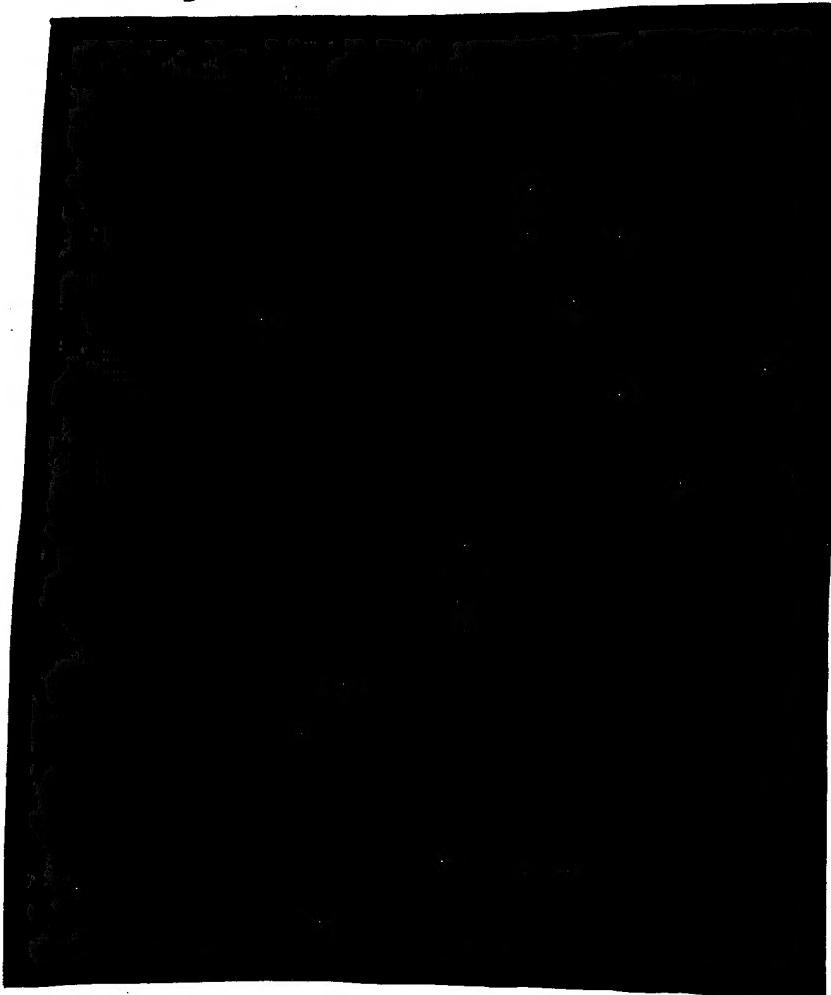
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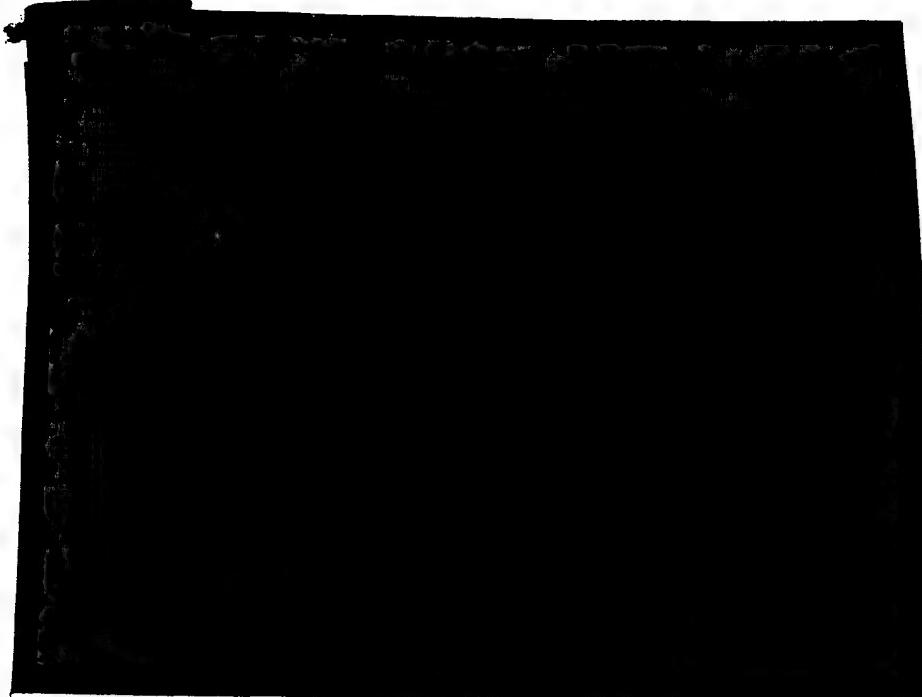
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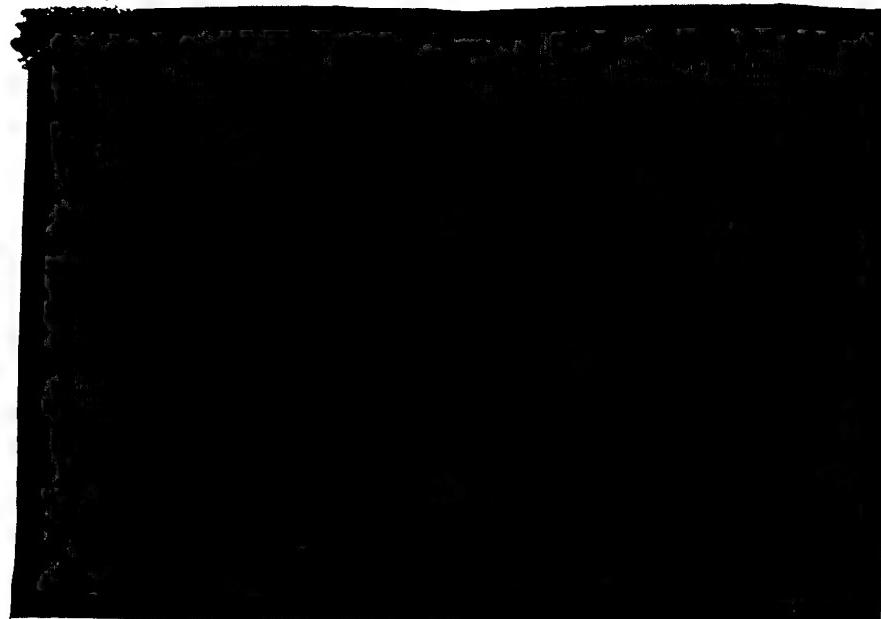
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POLAND: Reaction Mixed to Solidarity Coalition Proposal

Initial reaction has been mixed to Solidarity leader Walesa's call for a Solidarity-led coalition government that would include parties traditionally allied with the Communists. The Chairman of the United Peasant Party, Roman Malinowski, expressed skepticism, but [redacted]

[redacted] there was support for the move among Solidarity sympathizers in the rank and file of both parties. The United Peasant Party leadership began meetings to discuss the offer yesterday.

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[redacted] Walesa has managed at least temporarily to blunt heavy Communist criticism that the opposition is shirking its responsibility by refusing to join in a grand coalition under Premier Kiszcak. He has also shown those in the opposition who argue that Solidarity should moderate its all-or-nothing formula in favor of entering into a coalition with other non-Communist groups that he is willing to pursue the idea. The move also underscores the fragility any Communist-led coalition government will have, and it will probably prompt the Communists' junior partners to demand more influence on policy before they agree to serve in a Kiszcak cabinet. Top Solidarity strategists apparently hope that pressures created by offers such as Walesa's will lead to new, unexpected compromises and eventually to President Jaruzelski's acceptance of a Solidarity-led government.

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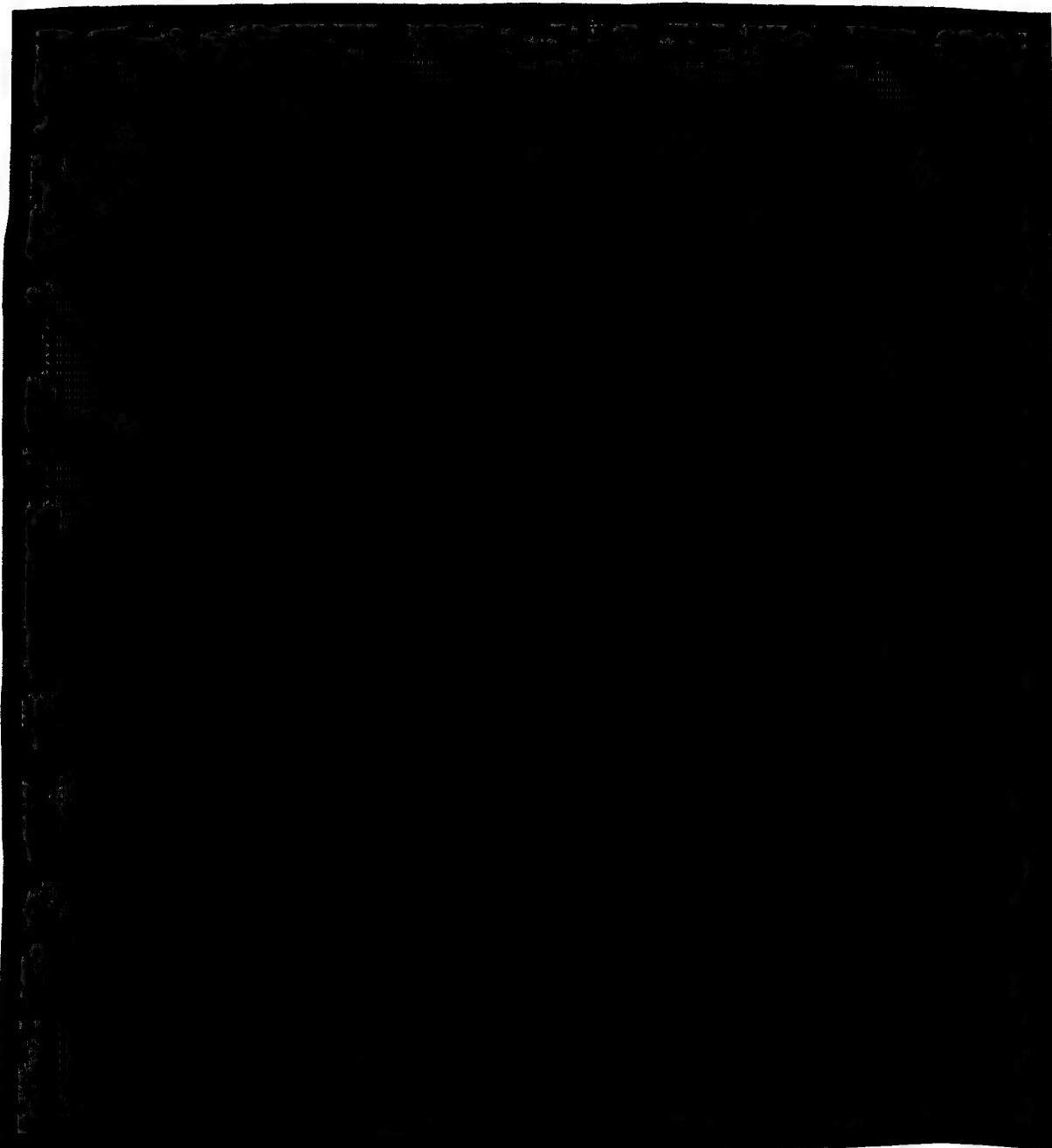
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SURINAME: Military Undermining Peace Accord

Suriname's military is continuing its attempts to undermine the peace accord with the rebels that the National Assembly approved on Monday. Military strongman Boutorse had announced last week that the Army would refuse to implement the accord, which calls for the insurgents to be integrated into police units maintaining security in the interior.



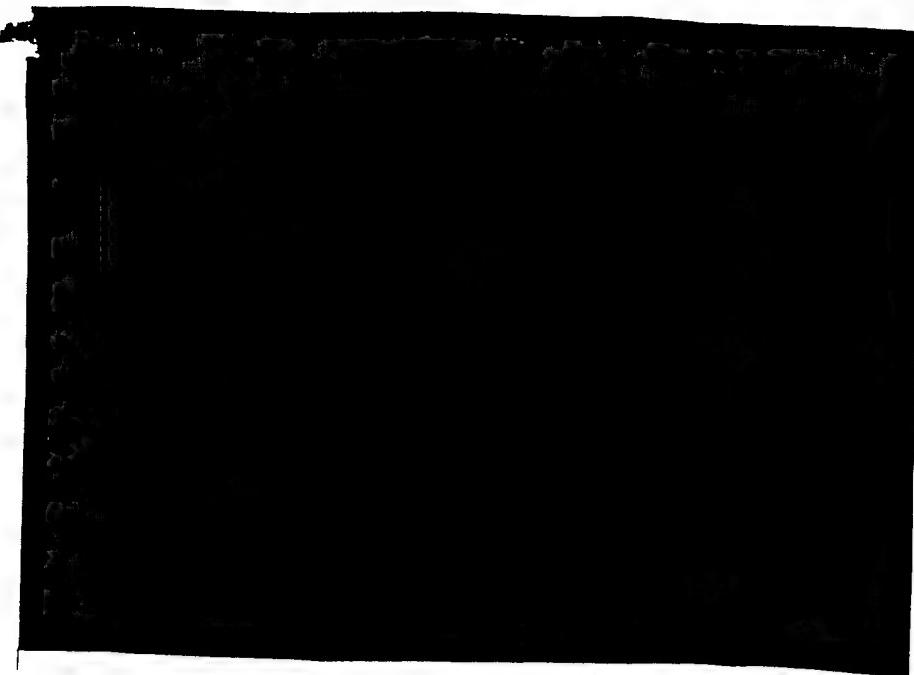
Despite the Assembly's approval of the accord, the government will probably make major concessions to the military and may even back out of the agreement altogether. At a minimum, the government will delay implementation, which might cause the accord to fall apart. The military probably will take advantage of delays to intensify pressure on the government and spread propaganda against the rebels. The insurgents—who already suspect the government is backing away from its commitments—are likely to become frustrated at the slow pace and turn again to fighting.

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In Brief

USSR

- Soviet Railways Ministry averted rail strike by quickly accepting demands for better working, living conditions. [REDACTED] follows similar handling of coal strike . . . may encourage other workers to increase demands. [REDACTED]
- Estonian legislature yesterday passed election law disenfranchising recent immigrants. Soviet soldiers . . . rejected Russian deputies' proposal to omit two-year residency requirement . . . local Russian workers threatening general strike today. [REDACTED]

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East Asia

- Chinese Vice Foreign Minister, Vietnamese Foreign Minister met Monday at Cambodia conference in Paris . . . highest level bilateral talks in 10 years . . . Vietnamese called meeting frank, open . . . to meet again during conference. [REDACTED]
- Philippine Government willing to start bases talks with US before Aquino visit in November . . . waiting to be asked, according to spokesman . . . to maintain pressure, also speeding contingency planning for commercial use of bases. [REDACTED]

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Americas

- Peruvian violent left bolted electoral coalition last week to back far-left presidential candidate . . . rest of coalition must decide whether to endorse relative moderate . . . disarray enhances prospects of center-rightist Vargas Llosa. [REDACTED]

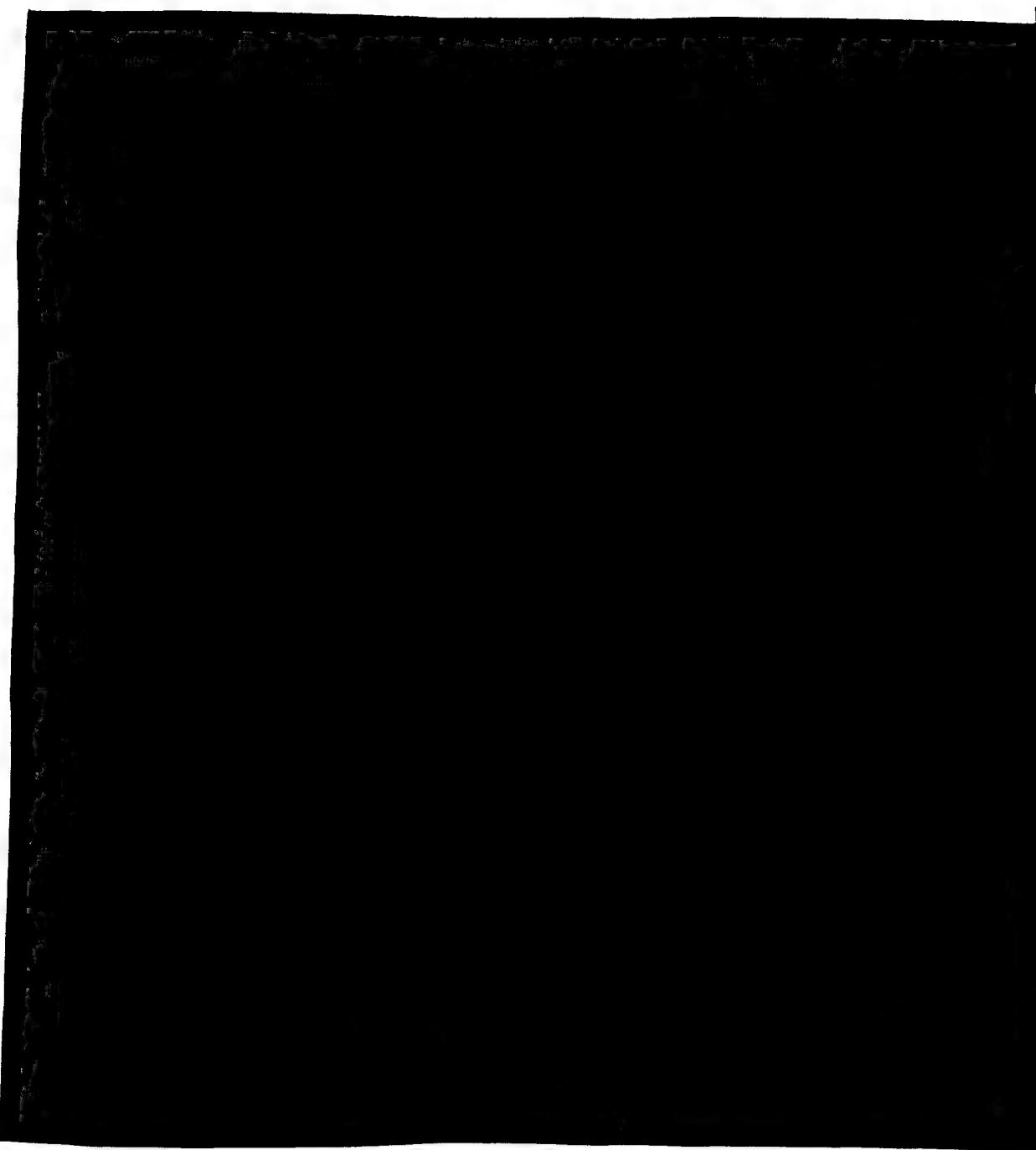
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Special Analysis

SOUTH KOREA: Economic Balancing Act

Buffeted by economic pressures at home and abroad, Seoul in the past month has tightened credit, issued wage guidelines, and vowed to halt currency appreciation to ease rising inflation and revive flagging economic growth. High wage increases, in particular, have eroded export competitiveness, and Seoul probably will have to move to formal wage controls by the end of the year if labor does not respond to government calls for moderation. In any case, President Roh will be reluctant to make concessions to trading partners on currency appreciation or agricultural liberalization.

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Seoul has scaled back this year's economic projections as performance has fallen below target on almost all fronts. Real GNP, after growing more than 12 percent in each of the past three years, rose at a year-over-year rate of less than 6 percent in the first quarter, largely because of a decline in exports. Inflation, meanwhile, is running about 2 percentage points above the government's 5-percent goal for the year and well above the 3-percent rate of recent years.

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Soaring wages, labor disruptions, and steep currency appreciation are the prime causes of slumping economic performance. Since first-quarter 1987, wages have risen by 60 percent and strikes have proliferated as democratic political reforms have emboldened unions and unleashed pent-up labor grievances. At the same time, Seoul has allowed the won to appreciate more than 20 percent in response to pressure from its trading partners. As export competitiveness has weakened, business has sharply scaled back investment and industrial production has plummeted.

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Seoul Responds

[redacted] the public's top economic concern is price stability. [redacted] the government is maintaining a restrictive monetary policy and, despite business complaints, has indicated it will tighten credit further in the second half of the year.

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The government also is edging away from its soft approach to labor. It has announced it will hold government pay raises below 10 percent and form labor-management committees to set wage guidelines for the private sector. To educate the public on the importance of wage restraint, the Economic Planning Board has issued projections

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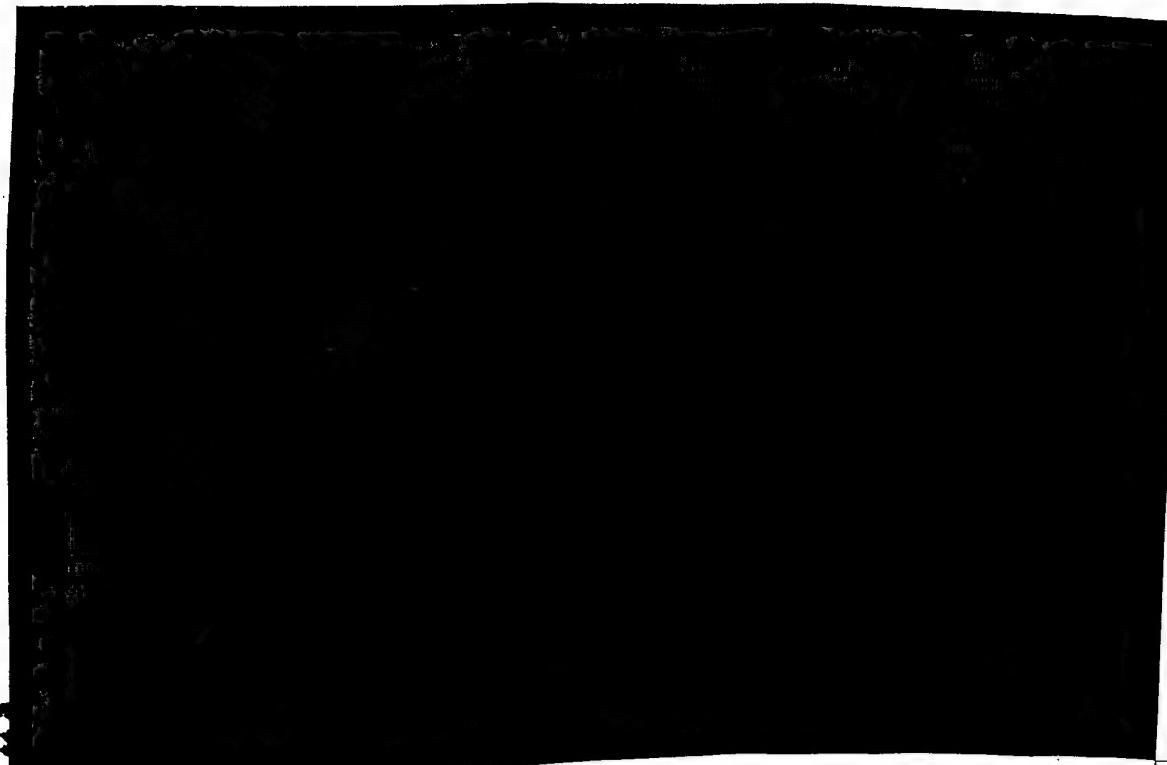
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showing the impact of different rates of wage growth: wage gains of 10 percent annually are said to result in growth of 7.5 percent and inflation of 5 percent, while salary hikes of 20 percent allegedly will yield growth of 3 to 5 percent and inflation of 10 percent. [redacted]

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Seoul wants to address foreign pressure with concessions on less sensitive trade issues and to delay movement in areas that have broader political and economic implications. To avoid being designated as an unfair trading partner under US trade law, for example, Seoul took significant steps to ease localization requirements and restrictions on foreign investment. It probably will continue this approach, taking a more conciliatory position with its trading partners on issues like telecommunications but digging in its heels on the liberalization of agriculture because farmers are one of the ruling party's key constituencies. [redacted]

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The Roh government is especially likely to resist pressure for won appreciation because of the 50-percent reduction in its current account surplus and the near eradication of the merchandise trade surplus in the first half of the year. [redacted] the won is at an "appropriate" level, will buttress the case against further appreciation. Several high-level Korean economic officials believe the won is overvalued, and Seoul's top economic policy maker has recently proposed a devaluation. Moreover, Seoul is under increasing pressure from Korean businessmen and political parties to depreciate the won to reflate exports. Seoul probably calculates its decreasing trade surplus has undercut US demand for appreciation. [redacted]

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Labor: Key to the Economic Outlook

If Seoul succeeds in getting labor on board, domestic pressure should ease markedly by the end of the year. Labor stability would reassure domestic investors, and the economy probably could maintain politically acceptable GNP growth rates of 6 to 7 percent. The current account probably would continue to decline, and imports, buoyed by brisk consumer demand and market-opening measures, would grow faster than exports, reducing the prominence of South Korea's surplus as an irritant to its trading partners. [redacted]

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If labor remains unruly, however, the economy probably will weaken further, and the choices facing Seoul will become more difficult. It would probably opt for a more stringent approach to labor demands, possibly including formal wage controls. And it would find itself under new pressure to depreciate the won in order to reflate the economy, the reaction of its trading partners notwithstanding. [redacted]

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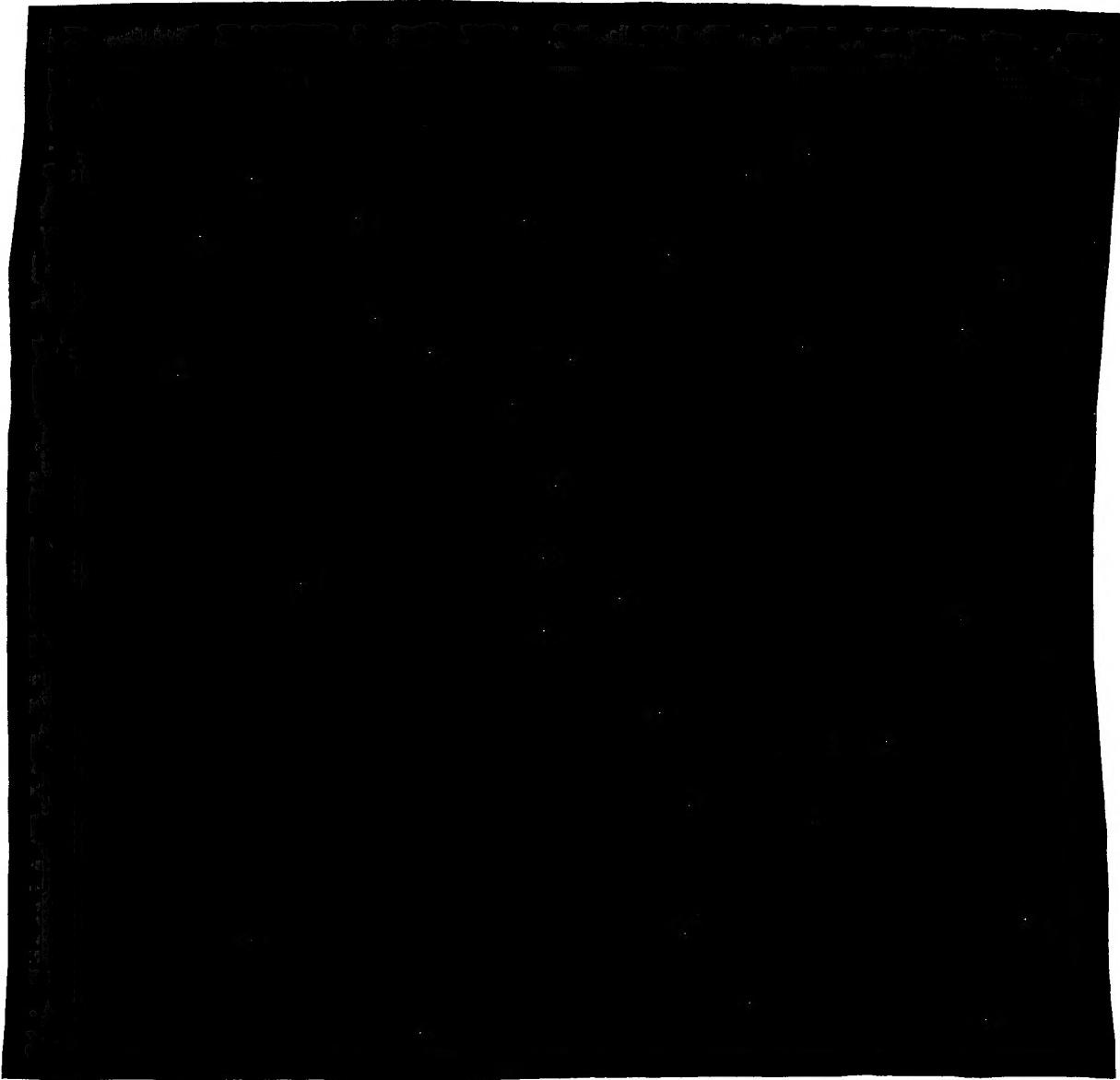
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Special Analysis

EAST GERMANY: After Honecker Who?

Although East German leader Honecker's recent illness does not appear serious, his advanced age (76), other indications he may soon step down, and divisions in the party over political and economic reform almost certainly have intensified maneuvering among his potential successors. The succession picture remains cloudy, but only Egon Krenz, the orthodox party secretary for security, youth, and sports, and populist East Berlin party boss Guenter Schabowski have the requisite mix of national prominence, relative youth, and access to the party inner circle. Neither is likely to make major policy changes if he becomes party leader.

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Schabowski is Krenz's chief rival. His populist style is like Soviet President Gorbachev's, and he uses his Berlin platform effectively to present himself as a pragmatic problem solver and a man of the people. Schabowski is careful, however, not to stray far from the orthodox party line on reform. Although he publicly applauds Gorbachev's domestic policies as necessary for the USSR, he has privately ridiculed many Soviet reforms. Schabowski's mix of populism and support for the party line may make him a candidate acceptable to both the orthodox elite and the liberal faction.

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In the Homestretch

The success or failure of East Bloc reform movements and the climate of East-West relations are crucial parts of the Honecker succession equation. If Poland or Hungary faces widespread violent unrest, if Gorbachev falters, or if new tensions surface in the East-West relationship, the traditionalist Krenz will almost certainly remain

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the predominantly hardline Politburo's choice. If reforms take firm root in Eastern Europe and if the current era of detente continues, however, the party elite may think Schabowski's populist style more likely to mollify the party's liberal wing and an increasingly restive population while staving off demands for radical reform. b3

Among mentioned darkhorses are district party leaders Siegfried Lorenz, Hans-Joachim Boehme, and Hans Modrow and party secretary Werner Jarowinsky. The party elite probably views them as compromise choices in the event of a stalemate between Krenz and Schabowski supporters. A "Chernenko" solution, having Honecker relinquish his post to one of his contemporaries, is unlikely. b3

Gorbachev undoubtedly would like to see Honecker replaced by a more reform-minded leader but is unlikely to try to accelerate the succession or openly support any contender while Honecker still has a firm grip on power. The Soviets prefer not to intervene in East European successions and generally trust their allies to make leadership choices they can accept. Gorbachev probably would prefer Schabowski to Krenz but would not object to the latter. b1, b3

Neither Krenz nor Schabowski would be likely to make major policy changes as party leader. The omnipresent example of prosperous, democratic West Germany means East Germany cannot move too far toward economic decentralization and political liberalization without calling into question its separate existence. Schabowski would be more likely than Krenz to introduce limited reforms but probably would concentrate on careful adjustments to existing political and economic structures. b1, b3

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